Gold. Political Risk Hedge. The Schadenfreude Trade.

The case for gold has never been stronger with the rise in geopolitical risk since 2016. Since 2000, the price of gold has risen sharply, at an annualized rate of nearly 14%, only to peak in 2012 before losing 40% in 3 years for an annualized rate of -7.4%. Since then it has risen erratically to the current height of over 1550, a gain of nearly 50% in 3 years or an annualized gain of over 9%.

The main uses of gold are jewellery and electronics. The rest of gold's utility is as a store of value. Gold's economic value is therefore mostly derived by its being an alternative to other financial instruments. It's value derives from the value of everything else. When other currencies are debased, the value of gold rises. When other assets are debased, the value of gold rises. When central banks cut rates to zero, when bonds yield less and less, when there is a surfeit of money, the scarcity and constancy of gold enhance its value.

Gold is also a hedge against political and social uncertainty. As inequality rises and with it, social unrest, indignation and anger, the value of gold rises.

The value of gold to an investor depends on increasing turbulence in the socio-political landscape and having sufficient numbers of other investors who hold less gold than they desire (or no gold.)

The risks to gold are:

Political risks subside. This is unlikely to happen in the near term given the US elections, but politics is more unpredictable than the economy or financial markets. If anything, conditions are conducive to a rise in political risk.

Central banks stop debasing currencies. This is unlikely to happen, although the debasement is unlikely to accelerate since central banks are at the limits of monetary policy.

Deflation sets in. This could happen even in a growth scenario if technology advances sufficient or if central banks cut rates further. The latter dynamics are controversial but appear to be empirically supported. The Fisher Effect and inertia of real interest rates obtains this result.

So, to own gold or not?

When my analysts recommend gold as a hedge to the ills of the world, I see that gold bugs essentially need a world in trouble and all others to be unprepared, and I tell them, “find a better way.”

When yield curves are sufficiently flat, a duration matched steepener is a positive carry trade with capital gains potential and is a hedge for risk assets if the fall in risk assets is substantial. In other words, it is not a good hedge for small or gradual declines.

When markets are flow driven and capital causes convergence in asset prices, often the convergence overlooks quality. Long high quality short low quality credit pairs can be low cost, sometimes zero cost hedges for long credit portfolios.

Shorting funding currencies is another cheap hedge. When markets turn risk off, funding of risk positions is unwound putting pressure on low yielding (sometimes zero or negative yielding) currencies used to fund those positions.